

FEDERAL RESERVE BANK OF NEW YORK

33 LIBERTY STREET

NEW YORK, N.Y. 10045-0001

TIMOTHY F. GEITHNER
PRESIDENT AND CEO

October 8, 2008

The Honorable Max Baucus
Chairman
Committee on Finance
United States Senate
Washington, DC 20510

The Honorable Charles Grassley
Ranking Member
Committee on Finance
United States Senate
Washington, DC 20510

Dear Chairman Baucus and Ranking Member Grassley:

Below are responses to the questions posed in your letter to Secretary Paulson, Chairman Bernanke, and me dated July 10, 2008. I sincerely apologize for the delay in responding to you. My staff will follow up immediately with Committee staff to make the arrangements referenced in my response to question #1 below.

1) Your initial response provided a list of the general categories of the assets contained in the collateral portfolio. Please identify and provide more specific and complete details regarding each asset within these general categories, including a list of hedges associated with those assets.

In order to maximize value in the sale or liquidation of the collateral portfolio, the Federal Reserve must manage the pool of collateral over a long-term horizon and liquidate it in an orderly fashion that is not affected by the unusual market pressures on liquidity that currently affect the market. Public disclosure of individual assets in the collateral pool and of the hedging strategies that are employed to reduce the risk in the portfolio would undermine our ability to best protect the taxpayer against loss on the liquidation of the portfolio. Nonetheless, in order to allow Congress to conduct appropriate oversight, the Federal Reserve Bank of New York ("FRBNY") will provide at FRBNY and on a confidential basis to the staff of the Committee greater details regarding the assets in the portfolio.

2) Please describe in detail how BlackRock was selected to be the manager of the assets.

BlackRock was selected under FRBNY's Acquisition Guidelines ("Guidelines"). The Guidelines recognize that exigent circumstances may require an exception to the normal competitive bidding process, subject to senior management approval. In light of the unique time pressures associated with the decision to support JPMC's acquisition of Bear Stearns, senior management at FRBNY carefully considered the issue and determined that an exception to the competitive bidding provisions of the Acquisition Guidelines was appropriate with respect to the selection of an investment manager. BlackRock was selected to manage the proposed collateral portfolio for its technical expertise, operational capacity, and track record.

3) (a) Please explain why Bear Stearns assets are being purchased through a limited liability corporation based in Delaware. (b) What is the status of your effort to establish the limited liability corporation?

On June 26, 2008, Bear Stearns' assets were transferred to Maiden Lane LLC, a limited liability company based in Delaware, which was incorporated on April 29, 2008. The decision to incorporate as an LLC was based on the tax pass-through feature of the LLC, the liability protection the LLC structure affords to its members, and the ability of its members to tailor the LLC form to suit their needs. The decision to incorporate in Delaware was based on the quality of Delaware law which is updated regularly to reflect current corporate developments, the flexibility of the Delaware statute, the speed in which administrative matters can be handled in Delaware, and our belief that it was appropriate in this context to incorporate in the United States.

4) (a) Please describe the process used by the Federal Reserve and BlackRock to select the Bear Stearns assets to be managed by the Delaware LLC. (b) Please provide any and all reports, memoranda, letters, or other written communications from BlackRock related to the selection and/or valuation of the assets.

(a) FRBNY determined that it was willing to accept as collateral for the proposed Bear Stearns credit facility only assets that met each of the following parameters: (i) U.S. dollar denominated; (ii) U.S. domiciled; and (iii) performing residential and commercial mortgages or investment-grade or Agency issued securities (and related hedges). A performing mortgage is a mortgage that was no more than 30 days past due (as of March 14, 2008), and an investment-grade security is a security rated BBB- or higher by all rating agencies that have rated the security (as of March 14, 2008), including at least one of the three principal credit rating agencies.

(b) See response to Question 1.

5. (a) Please describe in detail the precedent, if any, for the Federal Reserve managing the type of assets selected from Bear Stearns. (b) Please describe in detail the precedent, if any, for the Federal Reserve using an LLC to manage the assets.

(a) As explained in greater detail in the response to Question 7, FRBNY extended credit in connection with the acquisition of Bear Stearns by JPMC pursuant to section 13(3) of the Federal Reserve Act, which was enacted in 1932. Under section 13(3), in unusual and exigent circumstances, the Board may authorize any Reserve Bank to extend credit to any individual, partnership, or corporation if the Reserve Bank obtains evidence that the borrower is unable to secure adequate credit accommodations from other banking institutions. Credit extended under section 13(3) must be secured to the satisfaction of the Reserve Bank. From July 1932 to July 1936, several Reserve Banks made loans using section 13(3) authority to a number of individuals and businesses. Records indicate that these loans were secured by a diverse range of collateral, including common stock, commercial inventory, and receivables of the borrowing businesses.

(b) We have not identified any record indicating the prior use of a limited liability company to hold collateral securing an extension of credit made by a Reserve Bank pursuant to section 13(3).

6. (a) What is the Federal Reserve's plan for periodically reporting to the public on the value of the assets and the status of their disposition during the ten years the new Federal Reserve financing facility will be in place. (b) Will you provide the Committee with quarterly updates on the current valuations of the assets in comparison to the valuation on the date the assets were acquired?

(a) Beginning after June 26, 2008, the date the Bear Stearns financing transaction was closed, the Board's H.4.1. statistical release, "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks," includes information related to Maiden Lane, the limited liability company formed to acquire and manage the collateral for the Bear Stearns/JPMC financing transaction. Among other things, the release discloses, as of the date of the release, the aggregate fair value of Maiden Lane's net portfolio holdings and the book value of the principal and interest on the loans made to facilitate the Bear Stearns acquisition. Consistent with generally accepted accounting principles, the assets and liabilities of Maiden Lane have been consolidated with the assets and liabilities of FRBNY in the preparation of the statements of condition shown on the release because the Reserve Bank is the primary beneficiary of Maiden Lane. The H.4.1. release is published weekly on Thursdays and is available on the Board's public website.

(b) The fair value of Maiden Lane LLC's net portfolio holdings as of the date of acquisition, June 26, 2008, is disclosed in the H.4.1. Statistical Release issued by the Board of Governors on July 3, 2008. Thereafter, Maiden Lane LLC's net portfolio holdings will be updated quarterly and published on the H.4.1 release. Table 2 of this release includes a footnote that states the date the last time prices of portfolio holdings were revalued.

7. Former Federal Reserve Chairman Paul Volcker recently expressed the concern that the Federal Reserve's action in the Bear Stearns matter "extended to the very edge of its lawful and implied power, transcending certain long-embedded central banking principles and practices." (a) What is the legal basis for the assumption of control over the \$30 billion in assets? (b) Please provide copies of any and all memoranda, reports, or other written assessments or analysis of the legal issues surrounding the Federal Reserve's role in the transaction.

The legal basis for the Federal Reserve extension of credit in connection with the acquisition of Bear Stearns by JPMC is explained in a memorandum, dated April 2, 2008 from the Board's Legal Division to the Board of Governors. A copy of that memorandum will be provided by the Board of Governors.

8. (a) If by disposing of these assets the LLC suffered a loss of \$20 billion, what impact would that have on (1) the size of the Federal Reserve's balance sheet, (2) the Federal Reserve's annual remittance to the Treasury Department, (3) federal revenues, (4) the deficit, and (5) the debt held by the public? (b) What would be the impact on (a)(1)–(5) if the LLC realized a \$20 billion gain?

(a) Consistent with generally accepted accounting principles, the assets and liabilities of Maiden Lane, the limited liability company that holds the assets serving as the collateral for the Bear Stearns/JPMC financing transaction and that is liable for repayment of the credit extended in the transaction, are consolidated with the assets and liabilities of FRBNY in the preparation of the financial statements of the Federal Reserve Banks. Under the credit agreement, the subordinated lender to Maiden Lane, JPMC, would absorb the first \$1.15 billion of losses resulting from the decline in the value of the assets serving as collateral and any residual value of the collateral assets in excess of the obligations of Maiden Lane would be owed to FRBNY. The fair value of the net portfolio holdings of Maiden Lane is updated quarterly to reflect values at the end of each calendar quarter. If the revaluation of portfolio holdings indicates a decrease in value, FRBNY will reduce its carrying value of the asset and recognize an unrealized loss on any residual value not absorbed by JPMC. This loss, like any other Reserve Bank losses and expenses, will reduce the Bank's net earnings. The reduction in earnings would negatively affect the amount of the System earnings that are paid to the U.S. Treasury and the aggregate amount of federal revenues. Although the effect of such a reduction in System earnings on the overall Federal deficit and debt held by the public would depend on a number of economic and fiscal factors present at that time, and cannot be predicted reliably now, realized losses to the Reserve Bank, should they ultimately occur, would accrue to the government.

(b) Similarly, interest earned on the loan would accrue to and be payable to the government. Moreover, if, the revaluation of Maiden Lane portfolio holdings results in unrealized gains, FRBNY will increase its carrying value of the asset and will recognize an unrealized gain up to any unrealized losses previously recognized. Residual gains would then be accrued to JPMC up to its previously recognized loss. All remaining residual gains would then

be recognized by FRBNY. These gains, like any other Reserve Bank gains and income, will increase the Bank's net earnings. The increase in earnings would positively affect the amount of the System earnings that are paid to the U.S. Treasury and the aggregate amount of federal revenues. Although the effect of such an increase in System earnings on the overall Federal deficit, and debt held by the public would depend on a number of economic and fiscal factors present at that time, and cannot be predicted reliably now, realized gains to the Reserve Bank, should they ultimately occur, would accrue to the government.

9. Please explain why JPM was unwilling to include the assets now being managed by the LLC in their merger deal with Bear Stearns?

An agreement of the Federal Reserve on Sunday, March 16, 2008, to finance a portion of the assets of Bear Stearns was necessary to secure JPMC's agreement at that time (i) to acquire the remainder of the assets of Bear Stearns and (ii) to assume or guarantee the liabilities of Bear Stearns to allow it to open for business without disruption on Monday, March 17, 2008. As Jamie Dimon, the chief executive officer of JPMC, testified before the Senate Banking Committee on April 3, 2008, JPMC informed the New York Reserve Bank on March 16, 2008, that JPMC was unwilling to acquire all of Bear Stearns, and JPMC could not accept the risk of acquiring all the assets and liabilities of Bear Stearns in light of the substantial pre-existing exposure of JPMC to similar assets and liabilities.

10. (a) Please provide a copy of the contract between the New York Federal Reserve and the asset manager, BlackRock Financial Management, which will manage the collateral pool relating to the JPM loan. (b) How will BlackRock be compensated for its services? (c) What is its maximum potential fee? (c) What is its minimum potential fee? (d) Please describe what independent check, if any, there will be to assure that BlackRock's valuation of the assets is accurate and that its management of them is prudent.

We would like to invite your staff to visit FRBNY so that we can provide details on these arrangements on a strictly confidential basis. BlackRock's valuation of the assets is based partially on valuations provided by other agents working for Maiden Lane, LLC. FRBNY retains ultimate control over the policies governing the management and disposition of the collateral assets. At all times since BlackRock has been engaged, the management and senior staff of FRBNY have been involved on a day-to-day basis with the details of the portfolio management process. Experienced analysts and supervisors from FRBNY's Markets Group, Bank Supervision Group, and other areas have been assigned to monitor the portfolio and to carefully review BlackRock's investment management decisions.

11. In Congressional testimony James Dimon, Chairman of JPM, disclosed that the Federal Reserve has lent Bear Stearns \$25 billion under a new program of direct lending available to major investment banks—separate from the \$30 billion exchange of assets. (a) What is the status of that additional loan, or loans? (b) Please provide a history of borrowing by BSC through the Primary Dealer Credit

Facility for the period of March 1, 2008 through June 30, 2008. (c) Also, please provide a history of borrowing by JPM through the Primary Dealer Credit Facility for the period of March 1, 2008 through June 30, 2008.

Aggregate information regarding borrowings extended at the Primary Dealer Credit Facility is available in the weekly H.4.1. Statistical Release by the Board, which is available at <http://www.federalreserve.gov/releases/h41>. The Federal Reserve has agreed with participants in its Primary Dealer Credit Facility to maintain the confidentiality of the details of their participation. This is necessary in order to prevent any stigma that might be perceived from use of the facility from attaching to participants. Were this information to be made public, the usefulness of the facility would be greatly impaired.

12. We understand that Jamie Dimon, Chairman of JPM, is a Class A Board Member of the Federal Reserve Bank of New York. What steps did the Federal Reserve take to ensure that Mr. Dimon's Board membership did not influence the negotiations regarding the purchase of Bear Stearns by JPM and the arrangement on the \$30 billion in Bear Stearns assets.

Jamie Dimon, chief executive officer of JPMC, is one of nine members of the board of directors of FRBNY. Mr. Dimon did not participate in his role as a director of FRBNY in the negotiations between the Federal Reserve and JPMC. Neither Mr. Dimon nor any other FRBNY director participated in the approval of the credit facilities regarding Bear Stearns. Rather, Mr. Dimon participated solely on behalf of JPMC. FRBNY was represented at all times by its president, Timothy Geithner, and staff in negotiations with JPMC. Mr. Dimon has recused himself from any role as a member of the board of directors of the Reserve Bank in any matter related to the Bear Stearns credit facility.

Sincerely,

A handwritten signature in black ink, appearing to be 'T. Geithner', with a long horizontal line extending to the right.

Timothy F. Geithner
President and CEO